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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

COMPLETED

New Formula Needed To Calculate Interest Rate On Unpaid Taxes

ORIGINAL

Deficiencies in the formula used to calculate interest assessments on delinquent taxes deprived the Government of about $286 million in fiscal year 1979.

At present, the formula is adjusted every 2 years based on changes in the prime interest rate. As a result, the formula rates do not reflect, except by chance, the costs the Government actually incurs in connection with delinquent taxes--the costs of its own borrowings and credit administration. The problem is compounded by the practice of only making biennial adjustments in a period of rapidly and sharply shifting interest rates.

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COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

NEW FORMULA NEEDED TO CALCULATE INTEREST RATE ON UNPAID TAXES

D I G E S T

The formula IRS presently uses to calculate the interest rate on unpaid taxes fails to properly reflect the Government's costs for credit administration and its cost for borrowing money.

GAO estimates that in fiscal year 1979, the present formula deprived the Government of about $286 million in interest charges. This loss occurred because the interest rate did not properly reflect administrative costs and the rising cost of Federal borrowing. Conversely, in a period where the cost of Federal borrowing is declining the present formula could also cause interest to be overassessed to delinquent taxpayers.

Interest is the compensation received by creditors, the Government in the case of unpaid taxes, for the use of their money. GAO found that IRS' present interest rate formula does not

--assure that the Government recovers no more or less than the costs associated with unpaid taxes,

--provide for adjusting the interest rate frequently enough,

--encourage taxpayers to pay taxes promptly in all instances, or

--contribute to administrative efficiency.

THE GOVERNMENT SHOULD RECOVER COSTS ASSOCIATED WITH UNPAID TAXES

The IRS interest rate is recalculated once every 2 years using a formula based on 90 percent of the prime interest rate. This

rate resulted in interest assessments of $1.251 billion in fiscal year 1979. However, the assessments fell short of the Government's costs considered to be related to unpaid taxes. GAO estimated these costs to total $1.537 billion.

The costs included

--$1.305 billion in interest costs for funds to replace the unpaid taxes (see p. 6); and

--$232 million to process and collect unpaid taxes (see p. 7).

GAO believes that the formula for determining the interest rate to be assessed on unpaid taxes should be changed so that the Government is compensated for these costs. In September 1979, the month IRS' current interest rate was determined, the 1-year Treasury bill interest rate was 9.89 percent. To this should have been added an estimated operating cost component of 1.17 percent to cover administrative expenses. (See p. 7.) Thus, a rate of 11.06 percent would have been needed to fairly compensate the Government for its costs of financing and administering unpaid taxes. (Since this rate is also applied to refunds some of the additional interest assessed would be returned to taxpayers. See footnote 1, page 6.)

IRS' INTEREST RATE SHOULD BE ADJUSTED SEMIANNUALLY

Even if IRS' interest rate formula is restructured, it must be determined more often than every other year to accurately reflect the cost to the Government of unpaid taxes. In recent years interest rates have changed significantly over short periods of time. For example, in 1979, the prime rate rose 4 percentage points over a 5-month period. GAO estimates that if the IRS interest rate had been adjusted semiannually, interest assessments on taxes due in fiscal year 1979 would have been at least $119 million higher. (See p. 16.)

On the other hand, if the interest rate had been declining, a more frequent adjustment would have prevented taxpayers from being overassessed. GAO believes that adjusting the rate semiannually, using the 1-year Treasury bill rate and redetermining the overhead factor annually would keep the rate more in line with the Government's cost of unpaid taxes.

PRESENT INTEREST RATE DOES NOT ENCOURAGE PROMPT PAYMENT OF TAXES

The Congress, when establishing the present interest rate formula, noted that the rate resulting from the formula should encourage taxpayers to pay their correct taxes promptly. GAO's study indicates that when interest rates are generally rising, the present procedures for calculating interest rates on unpaid taxes will not encourage taxpayers to pay taxes promptly and may even discourage such payment. IRS' assessed interest is generally lower than the rate available in commercial money markets, thus discouraging prompt payment. In contrast, when interest rates are falling, taxpayers who have become delinquent in their tax payment should not be required to over-compensate the Government for costs related to collecting delinquent accounts. Adjusting the rate to reflect changes in money market rates would help to alleviate this problem.

IRS' INTEREST RATE SHOULD BE STATED TO TWO DECIMAL PLACES

The present interest formula provides for rounding the calculated interest rate to a whole percentage. Such a provision does little to advance its stated purpose of administrative convenience. (See p. 17.) IRS can easily calculate interest assessments regardless of whether the rate is a whole percent or a decimal. The rate calculated in October 1977 and used between February 1978 and January 1980 was rounded

from 6.42 percent to 6 percent. This procedure cost the Government at least $45 million in fiscal year 1979 alone.

For some periods, the interest rate may be rounded up, which would result in overassessing interest for some taxpayers. The interest rate formula should state the interest rate to two decimal places and, to avoid the necessity of changing the rate only hundredths of a percent, a minimum change of 0.25 percent should be required before a change can be made.

AGENCY COMMENTS AND GAO'S EVALUATION

In their comments, the Department of the Treasury and IRS correctly pointed out that it is difficult to determine an interest rate which would be fair to both the taxpayer and the Government on both over- and underpayments. They are currently considering a proposal to adjust IRS' interest rate to 100 percent of the prime. They believe this is the most appropriate rate since most taxpayers pay more than the prime rate to borrow money and receive less than the prime rate when lending money. In addition, they believe that sound business practices used by banks and other financial institutions cannot be applied to IRS, noting that collecting taxes is unlike granting a loan.

The criteria GAO applied in this review was that the Government should recover the full costs of providing special benefits or services to individuals or groups from those receiving such benefits. For purposes of this evaluation, GAO considered that the taxpayers who use low cost funds owed the Government (by reason of their failure to make timely payment of taxes) are receiving a special benefit.

When Treasury officials commented on Senate Bill S.999, which dealt with IRS' interest rate, they stated, "The payment of interest is an economic concept, it is not a punitive one." GAO agrees that interest is an

economic concept and therefore requires the use of sound business principles in its application.

In GAO's opinion, Government policy and sound business principles require that a new formula be used to calculate the interest rate assessed by IRS on delinquent taxes. This rate should fairly compensate the Government for the costs of financing and administering delinquent taxes. If these costs are not recovered from delinquent taxpayers, they must be recovered from all taxpayers.

RECOMMENDATIONS TO THE CONGRESS

The Congress should amend the Internal Revenue Code to require IRS to:

--Establish an interest rate reflecting the prevailing Government borrowing rate plus a factor for administrative expenses.

--Establish semiannual adjustments of the interest rate stating it to two decimal places and limiting changes to 0.25 percent or more.

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ABBREVIATIONS

IRS	Internal Revenue Service
GAO	General Accounting Office